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2012 Year-End Tax Planning



Given the current level of uncertainty, year-end tax planning for 2012 is extremely challenging. With a host of major tax provisions expiring at year-end, and new taxes taking effect January 1, 2013, some year-end moves have the potential for significant savings. But will new legislation change the tax landscape once again? It's impossible to say for sure. Your best bet is to evaluate your tax situation now, consider your options, and stay on top of late-breaking legislative developments.

Higher tax rates a significant consideration

A fairly common strategy at year-end is to try to shift income into the following year by, for example, deferring a year-end bonus, or delaying the collection of business debts, rents, and payments for services. This year, however, you have to consider any income timing moves very carefully.

That's because federal income tax rates are scheduled to jump in 2013. We'll go from six federal tax brackets (10%, 15%, 25%, 28%, 33%, and 35%) to five (15%, 28%, 31%, 36%, and 39.6%). The maximum rate that applies to long-term capital gains will generally increase from 15% to 20%. And while the current lower long-term capital gain rates apply to qualifying dividends, starting in 2013, dividends will be taxed as ordinary income.

Could the current federal income tax rates be extended yet again? Of course, but it's far from a certain bet. That means any moves you contemplate have to be considered in the context of several "what-if" scenarios.

New taxes also a factor

New Medicare taxes created by the health-care reform legislation passed in 2010 take effect January 1, 2013. Beginning then, the hospital insurance (HI) portion of the payroll tax--commonly referred to as the Medicare portion--increases by 0.9% for high-wage individuals. Also beginning in 2013, a new 3.8% Medicare contribution tax is imposed on the unearned

income of high-income individuals.

Who is affected? The 0.9% payroll tax increase affects those with wages exceeding \$200,000 (\$250,000 for married couples filing a joint federal income tax return, and \$125,000 for married individuals filing separately). The 3.8% contribution tax on unearned income applies to some or all of the net investment income of individuals with modified adjusted gross income that exceeds \$200,000 (\$250,000 for married couples filing a joint federal income tax return, and \$125,000 for married individuals filing separately).

Make sure to consider whether you'll be affected by these new taxes in 2013. Keep in mind also that the current 2% reduction in the Social Security portion of the Federal Insurance Contributions Act (FICA) payroll tax is one of the tax provisions that expire at the end of 2012.

Revisiting Roth conversions

If you've been debating whether to convert a traditional IRA or 401(k) account to a Roth account, it's worth giving the matter another hard look before the end of the year. When you convert a traditional IRA to a Roth IRA, or a traditional 401(k) account to a Roth 401(k) account, the converted funds are subject to federal income tax in the year that you make the conversion (except to the extent the funds represent nondeductible after-tax contributions).

With tax rates set to go up next year, waiting to do a conversion could mean that your immediate tax hit for doing the Roth conversion goes up as well. Converting now can also have a long-term benefit--future qualified distributions from Roth IRAs and Roth 401(k)s will be free from federal income tax. That could make a big difference in retirement if you're paying income tax at a higher rate at the time. Whether a Roth conversion makes sense for you depends on a number of factors; but if it makes sense for you, it might pay to think about acting this year, rather than waiting.

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One more thing to consider. If you convert a traditional IRA to a Roth IRA and it turns out to be the wrong decision (e.g., current tax rates get extended, and you think you would have been better off waiting to convert), you can recharacterize ("undo") the conversion. You'll have until October 15, 2013, to recharacterize a 2012 Roth conversion--effectively, treating the conversion as if it never happened for federal income tax purposes.

Looking closely at itemized deductions

It's sometimes possible to accelerate or defer deductions so that they can be claimed in one year instead of the other. For example, you might be able to accelerate deductions into 2012 by paying some deductible medical expenses, interest, or state and local taxes before the end of the year. Or, with higher tax rates coming next year, you might consider trying to postpone deductions so that you can claim them in 2013 rather than 2012, since a dollar in deductions will be worth more if the tax rate is higher.

There are a couple of things to keep in mind, though. The first is that, as things stand right now, in 2013 most itemized deductions (and personal exemptions, for that matter) will once again be phased out for individuals with higher adjusted gross incomes (AGIs). The second is that, starting in 2013, the itemized deduction "threshold" for claiming unreimbursed medical expenses increases from 7.5% of AGI to 10% of AGI (there's a temporary exception for individuals who are 65 and older). If your itemized deductions are going to be limited in 2013 because of these changes, deferring deductions to 2013 might not make sense.

AMT--a big wild card

If you're subject to the alternative minimum tax (AMT)--essentially a separate federal income tax system with its own rates and rules--it gets even more complicated. AMT effectively disallows a number of itemized deductions, making it a significant consideration when it comes to year-end planning. And, while a series of temporary AMT "fixes" have increased AMT exemption amounts since 2001, forestalling a dramatic increase in the number of individuals ensnared by the tax, the last such fix actually expired at the end of 2011. As things stand now, the AMT exemption amounts that apply for 2012 and 2013 are significantly lower than for 2011. As a result, unless Congress retroactively changes the

AMT rules, it's estimated that more than 30 million taxpayers (roughly 20% of all taxpayers) will be hit by the AMT in 2012. (Source: The Tax Policy Center, "T12-0169 - Baseline AMT Projections, Aggregate AMT Projections, 2011-2022," September 13, 2012.)

AMT Exemption Amounts	2011	2012 & 2013
Married filing jointly	\$74,450	\$45,000
Single or head of household	\$48,450	\$33,750
Married filing separately	\$37,225	\$22,500

Other important changes

The earned income tax credit, the child tax credit, the adoption credit, and the American Opportunity (Hope) tax credit all revert to prior, lower limits and (less generous) rules of application. Also gone in 2013 is the ability to deduct student loan interest on student loans after the first 60 months of required repayment.

Tax changes that were originally made to address a perceived "marriage penalty" also expire at the end of 2012. If you're married and file a joint return with your spouse, you'll see the effect in the form of a reduced 2013 standard deduction amount, as well as in lower 2013 tax bracket thresholds in the tax rate table (i.e., couples will move into higher rate brackets at lower levels of income).

Talk to a professional

When it comes to year-end tax planning, there's always a lot to think about. And this year is more complicated than usual. A financial professional can help you evaluate your situation, keep you apprised of any last-minute legislative developments, and determine if any year-end moves make sense for you.

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